

THE ECONOMIC SITUATION

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- ❑ **The mid-year economy: slow growth, excess capacity, low employment.**
- ❑ **Something is rotten in the state of Denmark.**
- ❑ **Employment recovery: a long bumpy road.**
- ❑ **This time is different.**
- ❑ **If countries are in trouble, what about the U.S. states?**
- ❑ **Mid-year summary.**

The Mid-Year Economy

Six months into 2010, what concise statements can we make about the U.S. economy? How about this? The U.S. economy is recovering from the Great Recession with factory production rising, retail sales improving, but construction activity still falling, along with most state revenues and with huge excess capacity remaining in all sectors, including banking and finance. With labor productivity high due to employment cutbacks and employment costs (not wages) rising, the high unemployment economy sees little chance of improving soon.

Meanwhile, credit market volcanoes and real volcanoes erupt across the globe, putting new pressures on the recovery prospects.

On considering the fact that trillions of dollars of junk bonds and related instruments once in the private sector are now on the balance sheets of federal agencies (Fed, FDIC, Freddie, Fannie), we might join Marcellus, an officer of the court in Shakespeare's Hamlet and say: "Something is rotten in the state of Denmark." Marcellus had just seen the ghost of Hamlet's father. Notice that he addressed the "state," not the country.



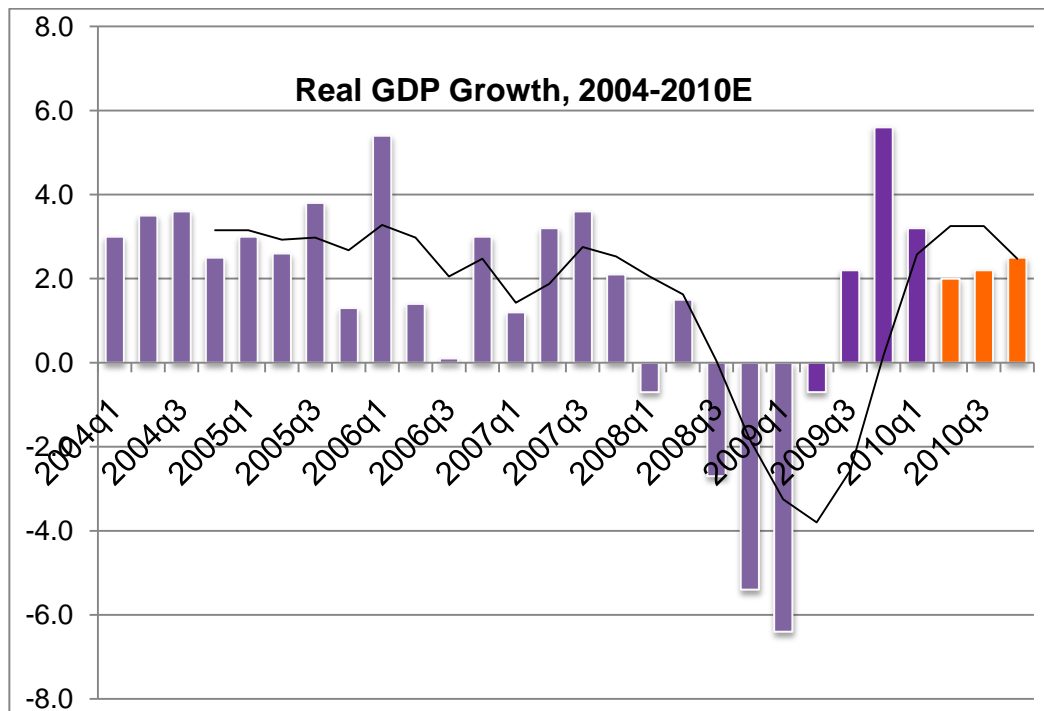
We have ghosts of the U.S. debt crisis still haunting us. The bad debt has been shuffled from the private to the public sector. But it is still there..., and much of it is rotten. World

credit markets question the meaning of the “full faith and credit of the United States government.”

Let's first consider data that mark the recovery and labor markets, what might be termed the good news. After that, we will take a closer at debt and deficits, the not-so-good news.

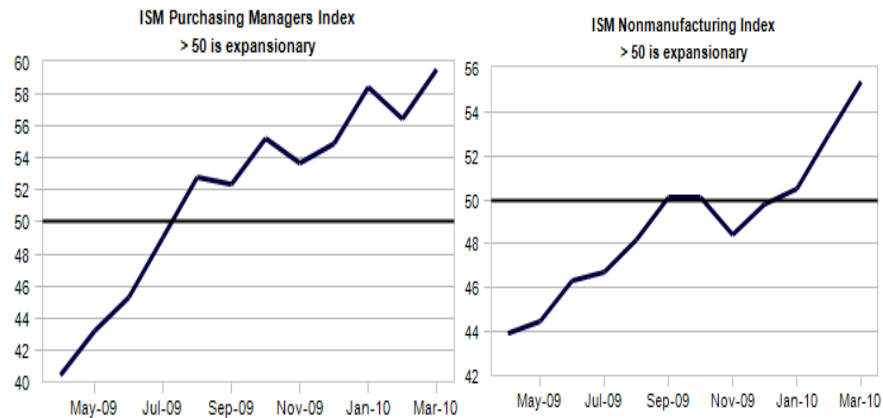
U.S. Recovery Indicators and Problems

When viewed in terms of real GDP growth, the U.S. economy is showing signs of recovered health, but part of that growth came from some now-ending injections provided by government spending. The accompanying chart shows the high 4Q2009 5.6 percent cash-for-clunkers-energized growth. Growth for 1Q2010 is understandably weaker, and subsequent growth is slated to be weaker still, due to the declining effects of various stimulus programs, bruised European economies, and slowing Chinese economy. This said, we should see the U.S. economy racking up 2010 growth in the high two percent, low three percent range when the final tally is recorded for the year.

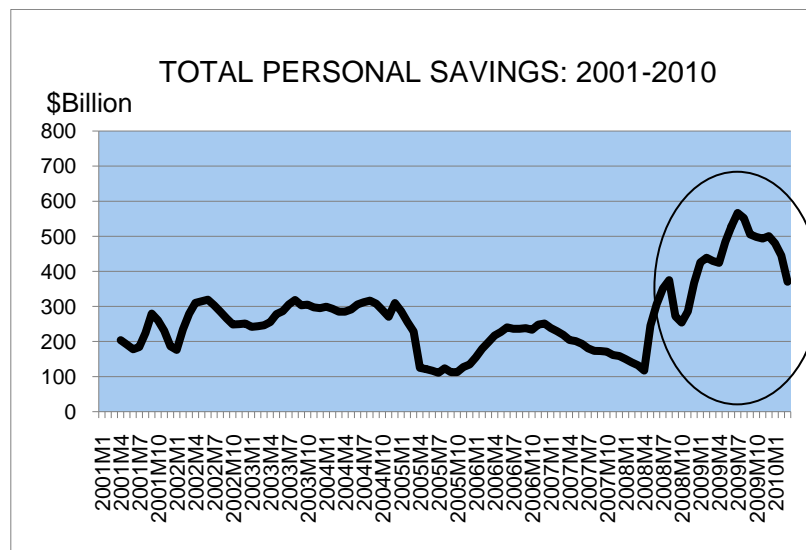


The sources of the recovering GDP growth can be traced to the manufacturing economy, which has experienced eight successive months of progress (above 50) as measured by the Purchasing Managers Index (PMI), and a smaller handful of positive months for the services sector PMI. These are seen in the next panel of charts. While examining the charts, please notice how far the economy has moved since June 2009.

TWO KEY U.S. INDICATORS

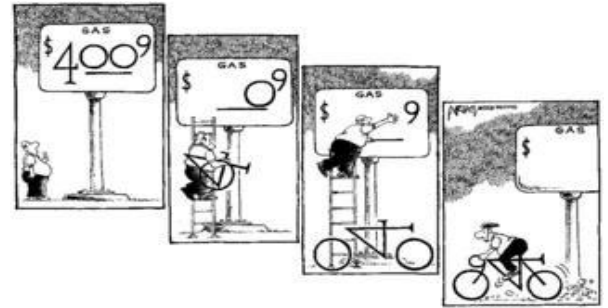


The large fear-driven spike in total personal savings that occurred in 2008 has now weakened somewhat. This means that retail sales are rising again as families and individuals relax a bit while still looking for the final sign of recovery: employment opportunities as signaled by a low unemployment rate. Total personal savings data are shown in the next panel.

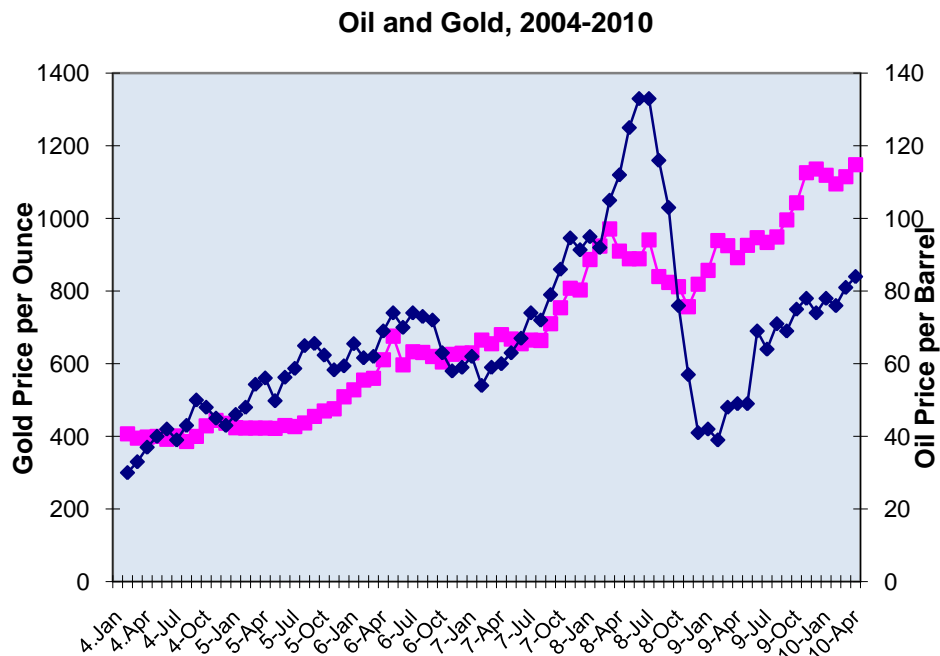


Economic slack is seen in the price of crude oil.

One sure sign of high excess capacity worldwide is seen in the price of crude oil relative to the price of gold. Typically, the two prices move together, reflecting demand for both commodities and inflation expectations. Notice the fall 2008 gap that emerged in the two time series in the next chart.

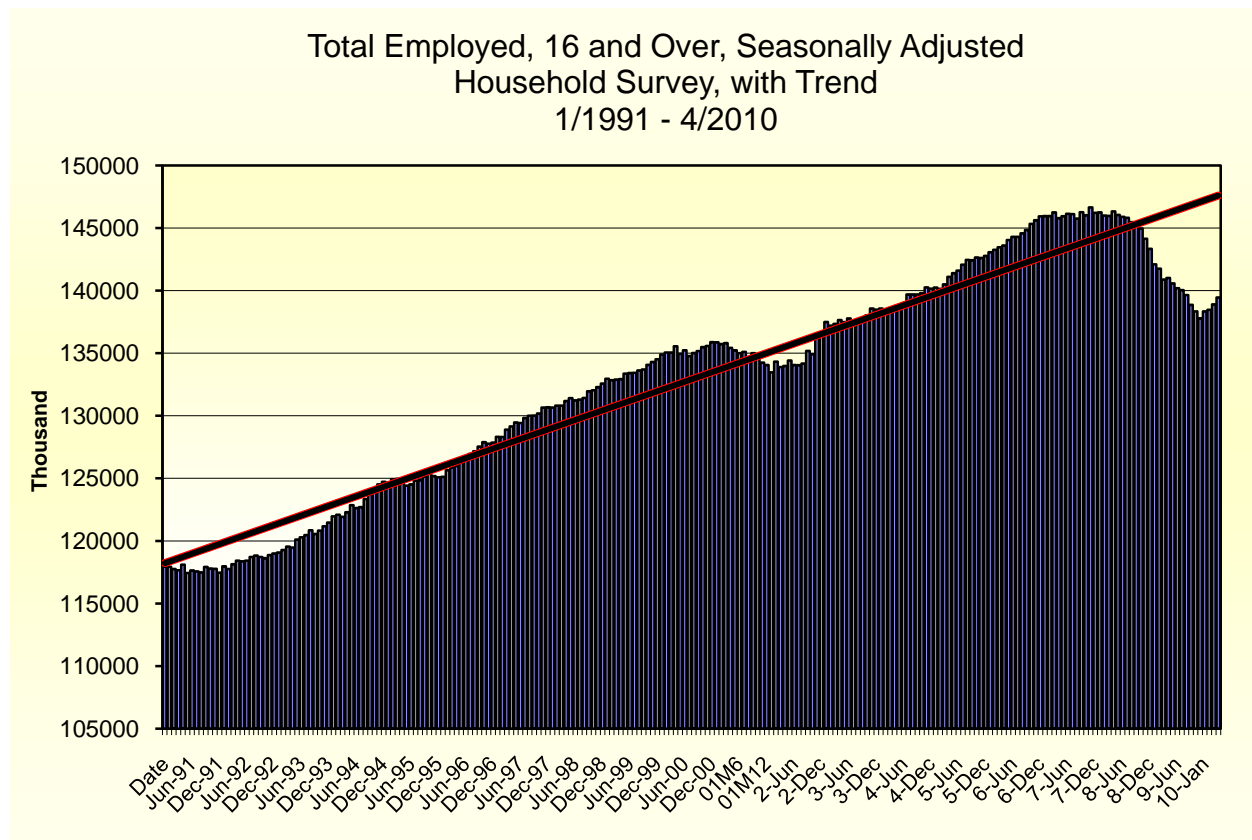


The gap continues somewhat unabated. Is there a forecast buried in the data? I think so, and have stated so before. Look for \$100 oil when recovery is on a sounder footing, perhaps in the first quarter of 2011.



Employment Recovery: a Long Bumpy Road

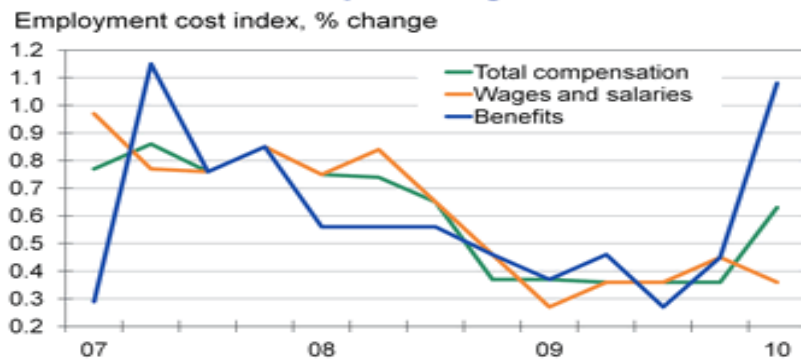
We have now seen four straight months of employment growth. Although small, the numbers include census workers and positive growth in manufacturing and other sectors, all from a very low base. As shown the next chart, total U.S. employment has surely bottomed out and is climbing recovery hill. Employment is now at the June 2004 level, some 6.7 million below the December 2007 level when the economy swooned.



Why the slow employment recovery?

Workforce gains are slow in coming for at least four reasons. First, when severe layoffs occur, the most productive workers are the last to go. This means labor productivity is unusually high; it takes fewer workers to expand output. With the economy slowly expanding, not many additional hires are needed.

Second, because labor productivity falls as additional workers are brought back, the incremental cost of output rises. Expanding the number of hours in the workweek is a better short-term fix when more production is needed. Third, as the economy advances, even in recession, the need for more qualified workers continues to grow. The April 2010 unemployment rate was 4.4 percent for adults with a bachelor's degree. And fourth, the cost of employment, which includes wages, fringe benefits, and related hiring costs, is rising rapidly. The growth in employment costs developed by economy.com is shown in the next chart.

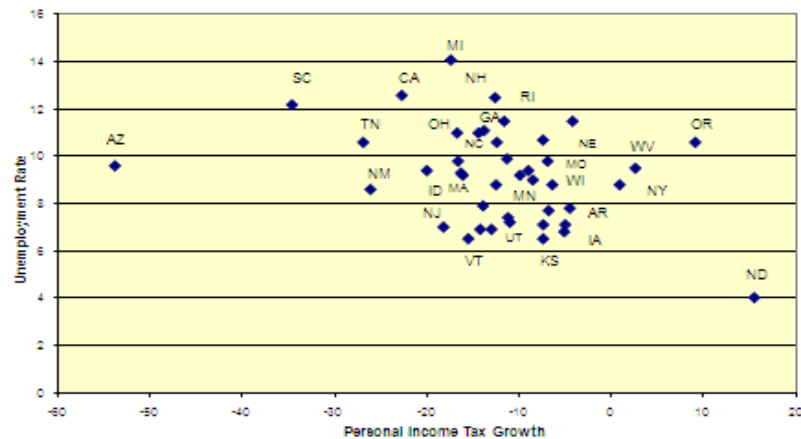


Unemployment and state personal income tax revenues.

A high unemployment economy creates lots of misery for individuals and families. Government revenues also fall, and related government services contract. The relationship between state unemployment rates for March 2010 and growth (decline) in personal income tax revenues across 2008-2009 is shown in the next chart.

South Carolina and Arizona have unusually large losses in personal income tax revenues relative to their unemployment rates.

Indeed, Arizona's revenues have fallen by more than 50 percent in the face of a severe real estate collapse and accompanying bankruptcies.

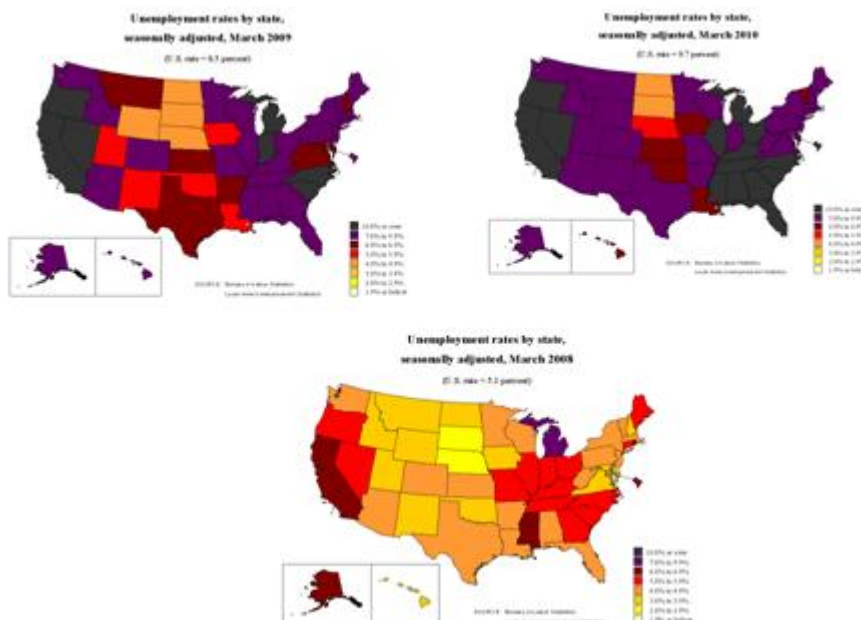


South Carolina's situation is more complex. The state has not suffered inordinately from the real estate

bubble collapse, but is caught in a transition from textile and other nondurable manufacturing to expanded services and lower employment manufacturing. Four states show positive growth in income tax revenues. North Dakota is apparently enjoying ethanol earnings, West Virginia must be gaining from coal, New York from Wall Street's recovery, and Oregon's diverse, recession-resistant economy barely showed negative income growth in 2009. The other states are bunched together in a pattern that shows a strong negative relationship between unemployment rates and personal income tax growth.

Unemployment's imprint across the states.

The overall employment difficulties generated by the Great Recession are seen in the next panel that shows unemployment maps for March 2008, 2009, and 2010. As indicated, the picture has become darker, year-by-year.



Lessons from Past Credit Meltdowns: This Time is Different

This Time is Different is the title of a new blockbuster book by economists Carmen Reinhart and Kenneth Rogoff that provides two hundred years of history and loads of data on bank panics and country defaults worldwide. The authors formed the title from statements made by people in authority when credit collapse and default were on the horizon. They always seemed to say that things would not be so bad this time.

This time is different.

Whether it was due to the invention of central banking, gold-backed currency,



deposit insurance, more and better qualified regulators, or more serious and wiser political oversight, the voices crying in the wilderness said not to worry. But Reinhart's and Rogoff's meticulous research tells us that when a nation continually borrows so that it can spend more than it produces, the results are always the same. Bank panics. Bond defaults. Destroyed or damaged currency..., and on average, three years of misery.

Their study indicates that it takes three years on average for a credit-damaged economy to regain its footing. Unfortunately, we seem to be facing a rolling series of financial catastrophes. We should hope that the three year delay between event and normal does not reset with each untoward event. With Greece close to the brink and Europe in bailout mood, we may be on the second leg of a recession.

According to Reinhart and Rogoff, here are now just 17 countries worldwide that have not defaulted on their debt: These are Australia, Belgium, Canada, Denmark, Finland, Hong Kong, Mauritius, Malaysia, Netherlands, New Zealand, Singapore, South Korea, Sweden, Taiwan, Thailand, United Kingdom, and the United States. All the rest have defaulted or had to reschedule their debt at one time or another.

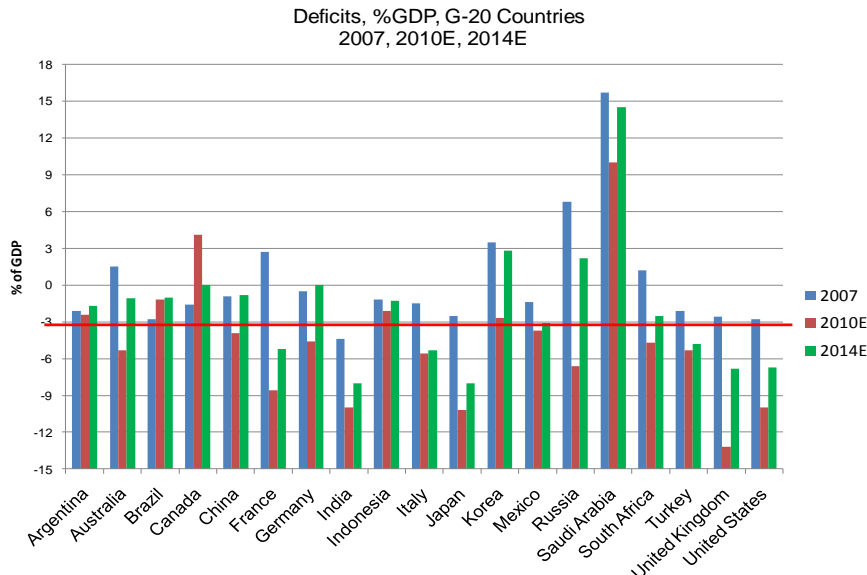
The current financial tremors across Europe are a case in point. Greece, a country that holds a historic blue ribbon for default on debt is an economy the size of New York; its debt represents two percent of total European Union debt, but the problem goes far beyond Greece. There are high debt countries like Spain, Portugal, Italy, and German and French banks that hold lots of Greek bonds on the balance sheets. And because the members of the Eurozone use the same currency but operate independent governments, the euro itself is at risk.

The three percent rule.

The Euro community was formed with a pledge that the member states would not run deficits in excess of three percent of their GDP and would hold debt to no more than 60 percent of GDP. The pledges were no doubt made in good faith at the time, but there was no constitution, no unified central monetary authority, and no sanctions to punish bad behavior. The deal was ripe for cheating, funny bookkeeping and beggar-my-neighbor behavior.

The three percent rule makes a lot of sense, as does the 60 percent rule. After all, there is only so much debt a person, business, or country can take on. The three percent rule says that if your economy grows three percent or better each year, on average, then three percent deficits can be sustained. Greece's deficit stands at better than 12 percent. (The U.S. is scheduled to hit 10 percent soon.)

When the three percent rule is applied to major countries we get the results shown in the accompanying figure. I have placed a deficit line in the chart at the three percent point.



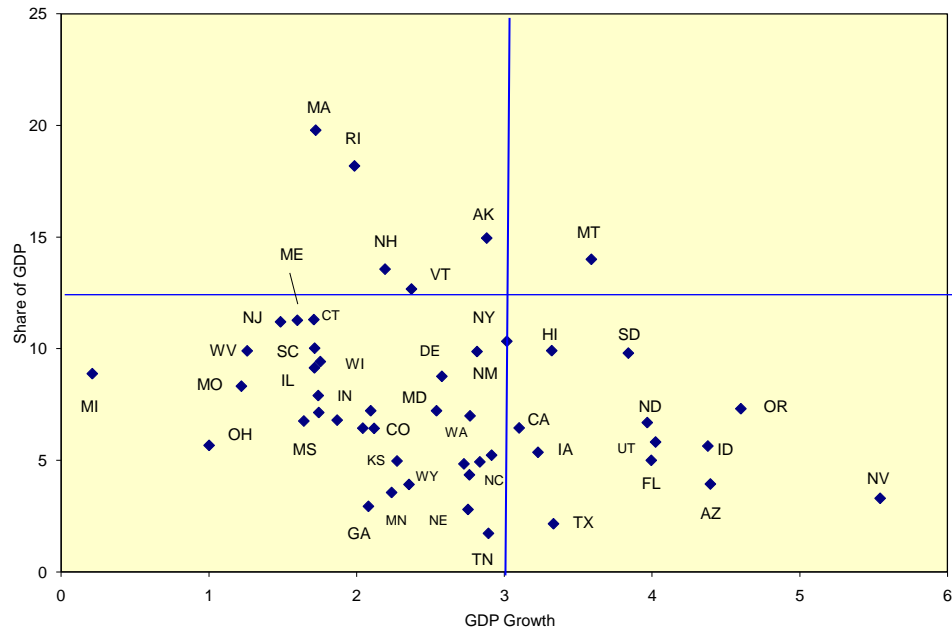
Notice that France, India, Italy, Japan, Turkey, United Kingdom, and the United States are each below the red line. These countries are in default risk territory. Most likely each one of them says “This time is different.”

What about the states?

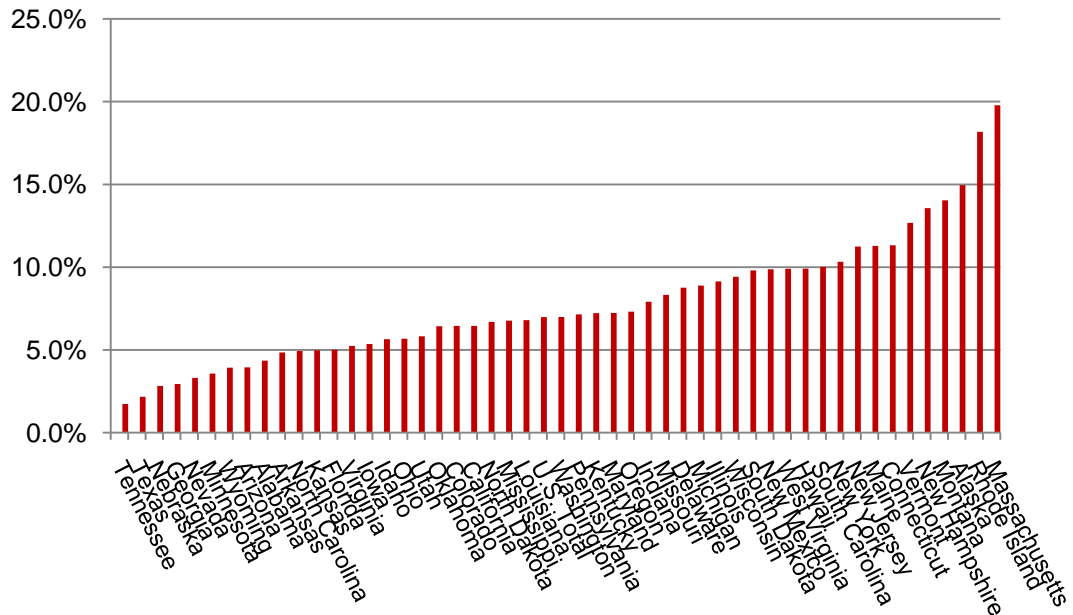
If debt is necessary, then sustainable debt seems like a good idea. What about the 50 states? How do they look when we map debt as a percent of state GDP against average state GDP growth over years prior to the Great Recession? The next chart, which shows the mapping, is divided into four quadrants. The northwest quadrant is where very high debt, low growth states are located. This is the region that contains Massachusetts, Rhode Island, New Hampshire, Vermont, and Alaska. Remember, this was before the Great Recession. The southeast quadrant is where low-debt, high-growth states are located. Here we see Arizona, Iowa, Texas, Florida, and California. The southwest quadrant contains relatively low-debt, but low-growth states.

Think what would happen if the three percent of GDP rule were applied to the states. About five would make the cut. Let's make it five percent to make the situation a bit more interesting. The next chart based on FY2007 data tells the tale.

State Debt, 2007 Share of GDP & Average Real GDP Growth, 2001-2005



State Debt as Percent of State GDP, FY2007



Final Thoughts

By many reliable measures, the U.S. economy has turned the corner on the Great Recession and is once again producing wealth. Comparable in some ways to climbing Mt. Everest in the face of an avalanche, the Great American Bread Machine has forged ahead in the face of credit market melts, massive government tinkering, high levels of fear and uncertainty, and till now, untested central bank and other government efforts to steer the economy to a solid growth path.

With GDP growing, employment expanding modestly, and export sales leading, the economy is now challenged by the ghosts of sub-prime mortgages and other junk-rated bonds and credit instruments that have moved from private sector balance sheets to the balance sheets of government agencies and enterprises.

Having turned the corner and now bouncing along a bumpy road, the challenge to be faced has to do with massive deficits, debt, and possible default on sovereign debt.

The economic plane is off the ground, but it is wise to keep seat belts fastened and trays locked in an upright position.

Given the uncertain path we are traveling, what can be said about the 2010's last half? Consider this summary:

- GDP growth will average more than 2.5 percent in the year's last half, giving almost 3 percent growth for the year.
- Employment will expand in all sectors but construction. The U.S. economy will end the year with a 9 percent unemployment rate.
- The European rough patch will be smoothed, but the fiscal stringency required will muffle regional economic growth and reduce U.S. exports to the region. The higher valued dollar will add to the export reductions, and lead to higher imports from Europe.
- Interest rates will remain calm, but the Fed will show signs of raising target interest rates in the last quarter. Indeed, we may see the first increase by year-end.
- With economic growth in the cards, there will be some price pressures on oil and other commodities. We should be on the look for \$100 oil bit not until 2011.